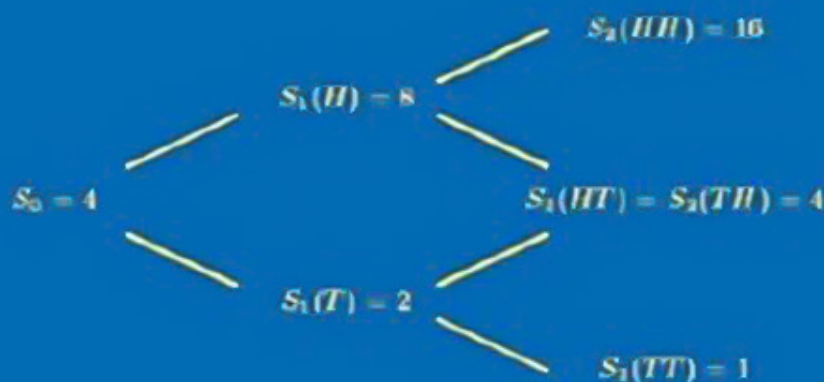


Steven E. Shreve

Stochastic Calculus for Finance I

The Binomial Asset Pricing Model



Springer

Steven Shreve: Stochastic Calculus and Finance

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Contents

1	Introduction to Probability Theory	11
1.1	The Binomial Asset Pricing Model	11
1.2	Finite Probability Spaces	16
1.3	Lebesgue Measure and the Lebesgue Integral	22
1.4	General Probability Spaces	30
1.5	Independence	40
1.5.1	Independence of sets	40
1.5.2	Independence of σ -algebras	41
1.5.3	Independence of random variables	42
1.5.4	Correlation and independence	44
1.5.5	Independence and conditional expectation.	45
1.5.6	Law of Large Numbers	46
1.5.7	Central Limit Theorem	47
2	Conditional Expectation	49
2.1	A Binomial Model for Stock Price Dynamics	49
2.2	Information	50
2.3	Conditional Expectation	52
2.3.1	An example	52
2.3.2	Definition of Conditional Expectation	53
2.3.3	Further discussion of Partial Averaging	54
2.3.4	Properties of Conditional Expectation	55
2.3.5	Examples from the Binomial Model	57
2.4	Martingales	58

3	Arbitrage Pricing	59
3.1	Binomial Pricing	59
3.2	General one-step APT	60
3.3	Risk-Neutral Probability Measure	61
3.3.1	Portfolio Process	62
3.3.2	Self-financing Value of a Portfolio Process Δ	62
3.4	Simple European Derivative Securities	63
3.5	The Binomial Model is Complete	64
4	The Markov Property	67
4.1	Binomial Model Pricing and Hedging	67
4.2	Computational Issues	69
4.3	Markov Processes	70
4.3.1	Different ways to write the Markov property	70
4.4	Showing that a process is Markov	73
4.5	Application to Exotic Options	74
5	Stopping Times and American Options	77
5.1	American Pricing	77
5.2	Value of Portfolio Hedging an American Option	79
5.3	Information up to a Stopping Time	81
6	Properties of American Derivative Securities	85
6.1	The properties	85
6.2	Proofs of the Properties	86
6.3	Compound European Derivative Securities	88
6.4	Optimal Exercise of American Derivative Security	89
7	Jensen's Inequality	91
7.1	Jensen's Inequality for Conditional Expectations	91
7.2	Optimal Exercise of an American Call	92
7.3	Stopped Martingales	94
8	Random Walks	97
8.1	First Passage Time	97

8.2	τ is almost surely finite	97
8.3	The moment generating function for τ	99
8.4	Expectation of τ	100
8.5	The Strong Markov Property	101
8.6	General First Passage Times	101
8.7	Example: Perpetual American Put	102
8.8	Difference Equation	106
8.9	Distribution of First Passage Times	107
8.10	The Reflection Principle	109
9	Pricing in terms of Market Probabilities: The Radon-Nikodym Theorem.	111
9.1	Radon-Nikodym Theorem	111
9.2	Radon-Nikodym Martingales	112
9.3	The State Price Density Process	113
9.4	Stochastic Volatility Binomial Model	116
9.5	Another Application of the Radon-Nikodym Theorem	118
10	Capital Asset Pricing	119
10.1	An Optimization Problem	119
11	General Random Variables	123
11.1	Law of a Random Variable	123
11.2	Density of a Random Variable	123
11.3	Expectation	124
11.4	Two random variables	125
11.5	Marginal Density	126
11.6	Conditional Expectation	126
11.7	Conditional Density	127
11.8	Multivariate Normal Distribution	129
11.9	Bivariate normal distribution	130
11.10	MGF of jointly normal random variables	130
12	Semi-Continuous Models	131
12.1	Discrete-time Brownian Motion	131

12.2	The Stock Price Process	132
12.3	Remainder of the Market	133
12.4	Risk-Neutral Measure	133
12.5	Risk-Neutral Pricing	134
12.6	Arbitrage	134
12.7	Stalking the Risk-Neutral Measure	135
12.8	Pricing a European Call	138
13	Brownian Motion	139
13.1	Symmetric Random Walk	139
13.2	The Law of Large Numbers	139
13.3	Central Limit Theorem	140
13.4	Brownian Motion as a Limit of Random Walks	141
13.5	Brownian Motion	142
13.6	Covariance of Brownian Motion	143
13.7	Finite-Dimensional Distributions of Brownian Motion	144
13.8	Filtration generated by a Brownian Motion	144
13.9	Martingale Property	145
13.10	The Limit of a Binomial Model	145
13.11	Starting at Points Other Than 0	147
13.12	Markov Property for Brownian Motion	147
13.13	Transition Density	149
13.14	First Passage Time	149
14	The Itô Integral	153
14.1	Brownian Motion	153
14.2	First Variation	153
14.3	Quadratic Variation	155
14.4	Quadratic Variation as Absolute Volatility	157
14.5	Construction of the Itô Integral	158
14.6	Itô integral of an elementary integrand	158
14.7	Properties of the Itô integral of an elementary process	159
14.8	Itô integral of a general integrand	162

14.9	Properties of the (general) Itô integral	163
14.10	Quadratic variation of an Itô integral	165
15	Itô's Formula	167
15.1	Itô's formula for one Brownian motion	167
15.2	Derivation of Itô's formula	168
15.3	Geometric Brownian motion	169
15.4	Quadratic variation of geometric Brownian motion	170
15.5	Volatility of Geometric Brownian motion	170
15.6	First derivation of the Black-Scholes formula	170
15.7	Mean and variance of the Cox-Ingersoll-Ross process	172
15.8	Multidimensional Brownian Motion	173
15.9	Cross-variations of Brownian motions	174
15.10	Multi-dimensional Itô formula	175
16	Markov processes and the Kolmogorov equations	177
16.1	Stochastic Differential Equations	177
16.2	Markov Property	178
16.3	Transition density	179
16.4	The Kolmogorov Backward Equation	180
16.5	Connection between stochastic calculus and KBE	181
16.6	Black-Scholes	183
16.7	Black-Scholes with price-dependent volatility	186
17	Girsanov's theorem and the risk-neutral measure	189
17.1	Conditional expectations under $\widetilde{\mathbb{P}}$	191
17.2	Risk-neutral measure	193
18	Martingale Representation Theorem	197
18.1	Martingale Representation Theorem	197
18.2	A hedging application	197
18.3	d -dimensional Girsanov Theorem	199
18.4	d -dimensional Martingale Representation Theorem	200
18.5	Multi-dimensional market model	200

19 A two-dimensional market model	203
19.1 Hedging when $-1 < \rho < 1$	204
19.2 Hedging when $\rho = 1$	205
20 Pricing Exotic Options	209
20.1 Reflection principle for Brownian motion	209
20.2 Up and out European call.	212
20.3 A practical issue	218
21 Asian Options	219
21.1 Feynman-Kac Theorem	220
21.2 Constructing the hedge	220
21.3 Partial average payoff Asian option	221
22 Summary of Arbitrage Pricing Theory	223
22.1 Binomial model, Hedging Portfolio	223
22.2 Setting up the continuous model	225
22.3 Risk-neutral pricing and hedging	227
22.4 Implementation of risk-neutral pricing and hedging	229
23 Recognizing a Brownian Motion	233
23.1 Identifying volatility and correlation	235
23.2 Reversing the process	236
24 An outside barrier option	239
24.1 Computing the option value	242
24.2 The PDE for the outside barrier option	243
24.3 The hedge	245
25 American Options	247
25.1 Preview of perpetual American put	247
25.2 First passage times for Brownian motion: first method	247
25.3 Drift adjustment	249
25.4 Drift-adjusted Laplace transform	250
25.5 First passage times: Second method	251

25.6	Perpetual American put	252
25.7	Value of the perpetual American put	256
25.8	Hedging the put	257
25.9	Perpetual American contingent claim	259
25.10	Perpetual American call	259
25.11	Put with expiration	260
25.12	American contingent claim with expiration	261
26	Options on dividend-paying stocks	263
26.1	American option with convex payoff function	263
26.2	Dividend paying stock	264
26.3	Hedging at time t_1	266
27	Bonds, forward contracts and futures	267
27.1	Forward contracts	269
27.2	Hedging a forward contract	269
27.3	Future contracts	270
27.4	Cash flow from a future contract	272
27.5	Forward-future spread	272
27.6	Backwardation and contango	273
28	Term-structure models	275
28.1	Computing arbitrage-free bond prices: first method	276
28.2	Some interest-rate dependent assets	276
28.3	Terminology	277
28.4	Forward rate agreement	277
28.5	Recovering the interest $r(t)$ from the forward rate	278
28.6	Computing arbitrage-free bond prices: Heath-Jarrow-Morton method	279
28.7	Checking for absence of arbitrage	280
28.8	Implementation of the Heath-Jarrow-Morton model	281
29	Gaussian processes	285
29.1	An example: Brownian Motion	286
30	Hull and White model	293

30.1 Fiddling with the formulas	295
30.2 Dynamics of the bond price	296
30.3 Calibration of the Hull & White model	297
30.4 Option on a bond	299
31 Cox-Ingersoll-Ross model	303
31.1 Equilibrium distribution of $r(t)$	306
31.2 Kolmogorov forward equation	306
31.3 Cox-Ingersoll-Ross equilibrium density	309
31.4 Bond prices in the CIR model	310
31.5 Option on a bond	313
31.6 Deterministic time change of CIR model	313
31.7 Calibration	315
31.8 Tracking down $\varphi'(0)$ in the time change of the CIR model	316
32 A two-factor model (Duffie & Kan)	319
32.1 Non-negativity of Y	320
32.2 Zero-coupon bond prices	321
32.3 Calibration	323
33 Change of numéraire	325
33.1 Bond price as numéraire	327
33.2 Stock price as numéraire	328
33.3 Merton option pricing formula	329
34 Brace-Gatarek-Musiela model	335
34.1 Review of HJM under risk-neutral $\mathbb{P}$	335
34.2 Brace-Gatarek-Musiela model	336
34.3 LIBOR	337
34.4 Forward LIBOR	338
34.5 The dynamics of $L(t, \tau)$	338
34.6 Implementation of BGM	340
34.7 Bond prices	342
34.8 Forward LIBOR under more forward measure	343

34.9 Pricing an interest rate caplet	343
34.10 Pricing an interest rate cap	345
34.11 Calibration of BGM	345
34.12 Long rates	346
34.13 Pricing a swap	346

Chapter 1

Introduction to Probability Theory

1.1 The Binomial Asset Pricing Model

The *binomial asset pricing model* provides a powerful tool to understand arbitrage pricing theory and probability theory. In this course, we shall use it for both these purposes.

In the binomial asset pricing model, we model stock prices in discrete time, assuming that at each step, the stock price will change to one of two possible values. Let us begin with an initial positive stock price S_0 . There are two positive numbers, d and u , with

$$0 < d < u, \tag{1.1}$$

such that at the next period, the stock price will be either dS_0 or uS_0 . Typically, we take d and u to satisfy $0 < d < 1 < u$, so change of the stock price from S_0 to dS_0 represents a *downward* movement, and change of the stock price from S_0 to uS_0 represents an *upward* movement. It is common to also have $d = \frac{1}{u}$, and this will be the case in many of our examples. However, strictly speaking, for what we are about to do we need to assume only (1.1) and (1.2) below.

Of course, stock price movements are much more complicated than indicated by the binomial asset pricing model. We consider this simple model for three reasons. First of all, within this model the concept of arbitrage pricing and its relation to risk-neutral pricing is clearly illuminated. Secondly, the model is used in practice because with a sufficient number of steps, it provides a good, computationally tractable approximation to continuous-time models. Thirdly, within the binomial model we can develop the theory of conditional expectations and martingales which lies at the heart of continuous-time models.

With this third motivation in mind, we develop notation for the binomial model which is a bit different from that normally found in practice. Let us imagine that we are tossing a coin, and when we get a “Head,” the stock price moves up, but when we get a “Tail,” the price moves down. We denote the price at time 1 by $S_1(H) = uS_0$ if the toss results in head (H), and by $S_1(T) = dS_0$ if it

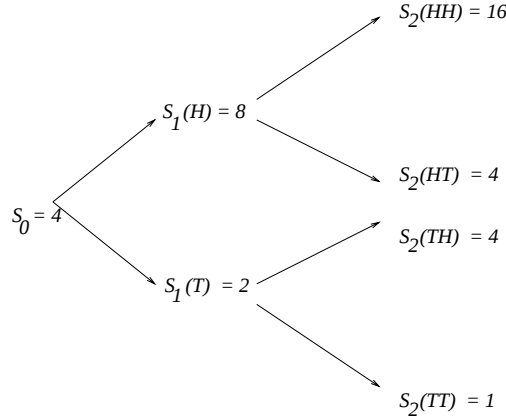


Figure 1.1: *Binomial tree of stock prices with $S_0 = 4$, $u = 1/d = 2$.*

results in tail (T). After the second toss, the price will be one of:

$$S_2(HH) = uS_1(H) = u^2S_0, \quad S_2(HT) = dS_1(H) = duS_0,$$

$$S_2(TH) = uS_1(T) = udS_0, \quad S_2(TT) = dS_1(T) = d^2S_0.$$

After three tosses, there are eight possible coin sequences, although not all of them result in different stock prices at time 3.

For the moment, let us assume that the third toss is the last one and denote by

$$\Omega = \{HHH, HHT, HTH, HTT, THH, THT, TTH, TTT\}$$

the set of all possible outcomes of the three tosses. The set Ω of all possible outcomes of a random experiment is called the *sample space* for the experiment, and the elements ω of Ω are called *sample points*. In this case, each sample point ω is a sequence of length three. We denote the k -th component of ω by ω_k . For example, when $\omega = HTH$, we have $\omega_1 = H$, $\omega_2 = T$ and $\omega_3 = H$.

The stock price S_k at time k depends on the coin tosses. To emphasize this, we often write $S_k(\omega)$. Actually, this notation does not quite tell the whole story, for while S_3 depends on all of ω , S_2 depends on only the first two components of ω , S_1 depends on only the first component of ω , and S_0 does not depend on ω at all. Sometimes we will use notation such $S_2(\omega_1, \omega_2)$ just to record more explicitly how S_2 depends on $\omega = (\omega_1, \omega_2, \omega_3)$.

Example 1.1 Set $S_0 = 4$, $u = 2$ and $d = \frac{1}{2}$. We have then the binomial “tree” of possible stock prices shown in Fig. 1.1. Each sample point $\omega = (\omega_1, \omega_2, \omega_3)$ represents a path through the tree. Thus, we can think of the sample space Ω as either the set of all possible outcomes from three coin tosses or as the set of all possible paths through the tree.

To complete our binomial asset pricing model, we introduce a *money market* with *interest rate* r ; \$1 invested in the money market becomes $\$(1 + r)$ in the next period. We take r to be the interest

rate for both *borrowing* and *lending*. (This is not as ridiculous as it first seems, because in a many applications of the model, an agent is either borrowing or lending (not both) and knows in advance which she will be doing; in such an application, she should take r to be the rate of interest for her activity.) We assume that

$$d < 1 + r < u. \quad (1.2)$$

The model would not make sense if we did not have this condition. For example, if $1 + r \geq u$, then the rate of return on the money market is always at least as great as and sometimes greater than the return on the stock, and no one would invest in the stock. The inequality $d \geq 1 + r$ cannot happen unless either r is negative (which never happens, except maybe once upon a time in Switzerland) or $d \geq 1$. In the latter case, the stock does not really go “down” if we get a tail; it just goes up less than if we had gotten a head. One should borrow money at interest rate r and invest in the stock, since even in the worst case, the stock price rises at least as fast as the debt used to buy it.

With the stock as the underlying asset, let us consider a *European call option* with strike price $K > 0$ and expiration time 1. This option confers the right to buy the stock at time 1 for K dollars, and so is worth $S_1 - K$ at time 1 if $S_1 - K$ is positive and is otherwise worth zero. We denote by

$$V_1(\omega) = (S_1(\omega) - K)^+ \triangleq \max\{S_1(\omega) - K, 0\}$$

the value (payoff) of this option at expiration. Of course, $V_1(\omega)$ actually depends only on ω_1 , and we can and do sometimes write $V_1(\omega_1)$ rather than $V_1(\omega)$. Our first task is to compute the *arbitrage price* of this option at time zero.

Suppose at time zero you sell the call for V_0 dollars, where V_0 is still to be determined. You now have an obligation to pay off $(uS_0 - K)^+$ if $\omega_1 = H$ and to pay off $(dS_0 - K)^+$ if $\omega_1 = T$. At the time you sell the option, you don't yet know which value ω_1 will take. You *hedge* your short position in the option by buying Δ_0 shares of stock, where Δ_0 is still to be determined. You can use the proceeds V_0 of the sale of the option for this purpose, and then borrow if necessary at interest rate r to complete the purchase. If V_0 is more than necessary to buy the Δ_0 shares of stock, you invest the residual money at interest rate r . In either case, you will have $V_0 - \Delta_0 S_0$ dollars invested in the money market, where this quantity might be negative. You will also own Δ_0 shares of stock. If the stock goes up, the value of your portfolio (excluding the short position in the option) is

$$\Delta_0 S_1(H) + (1 + r)(V_0 - \Delta_0 S_0),$$

and you need to have $V_1(H)$. Thus, you want to choose V_0 and Δ_0 so that

$$V_1(H) = \Delta_0 S_1(H) + (1 + r)(V_0 - \Delta_0 S_0). \quad (1.3)$$

If the stock goes down, the value of your portfolio is

$$\Delta_0 S_1(T) + (1 + r)(V_0 - \Delta_0 S_0),$$

and you need to have $V_1(T)$. Thus, you want to choose V_0 and Δ_0 to also have

$$V_1(T) = \Delta_0 S_1(T) + (1 + r)(V_0 - \Delta_0 S_0). \quad (1.4)$$

These are two equations in two unknowns, and we solve them below

Subtracting (1.4) from (1.3), we obtain

$$V_1(H) - V_1(T) = \Delta_0(S_1(H) - S_1(T)), \quad (1.5)$$

so that

$$\Delta_0 = \frac{V_1(H) - V_1(T)}{S_1(H) - S_1(T)}. \quad (1.6)$$

This is a discrete-time version of the famous “delta-hedging” formula for derivative securities, according to which the number of shares of an underlying asset a hedge should hold is the derivative (in the sense of calculus) of the value of the derivative security with respect to the price of the underlying asset. This formula is so pervasive that when a practitioner says “delta”, she means the derivative (in the sense of calculus) just described. Note, however, that my *definition* of Δ_0 is the number of shares of stock one holds at time zero, and (1.6) is a consequence of this definition, not the definition of Δ_0 itself. Depending on how uncertainty enters the model, there can be cases in which the number of shares of stock a hedge should hold is not the (calculus) derivative of the derivative security with respect to the price of the underlying asset.

To complete the solution of (1.3) and (1.4), we substitute (1.6) into either (1.3) or (1.4) and solve for V_0 . After some simplification, this leads to the formula

$$V_0 = \frac{1}{1+r} \left[\frac{1+r-d}{u-d} V_1(H) + \frac{u-(1+r)}{u-d} V_1(T) \right]. \quad (1.7)$$

This is the *arbitrage price* for the European call option with payoff V_1 at time 1. To simplify this formula, we define

$$\tilde{p} \triangleq \frac{1+r-d}{u-d}, \quad \tilde{q} \triangleq \frac{u-(1+r)}{u-d} = 1 - \tilde{p}, \quad (1.8)$$

so that (1.7) becomes

$$V_0 = \frac{1}{1+r} [\tilde{p} V_1(H) + \tilde{q} V_1(T)]. \quad (1.9)$$

Because we have taken $d < u$, both $\tilde{p}$ and $\tilde{q}$ are defined, i.e., the denominator in (1.8) is not zero. Because of (1.2), both $\tilde{p}$ and $\tilde{q}$ are in the interval $(0, 1)$, and because they sum to 1, we can regard them as probabilities of H and T , respectively. They are the *risk-neutral* probabilities. They appeared when we solved the two equations (1.3) and (1.4), and have nothing to do with the actual probabilities of getting H or T on the coin tosses. In fact, at this point, they are nothing more than a convenient tool for writing (1.7) as (1.9).

We now consider a European call which pays off K dollars at time 2. At expiration, the payoff of this option is $V_2 \triangleq (S_2 - K)^+$, where V_2 and S_2 depend on ω_1 and ω_2 , the first and second coin tosses. We want to determine the arbitrage price for this option at time zero. Suppose an agent sells the option at time zero for V_0 dollars, where V_0 is still to be determined. She then buys Δ_0 shares

of stock, investing $V_0 - \Delta_0 S_0$ dollars in the money market to finance this. At time 1, the agent has a portfolio (excluding the short position in the option) valued at

$$X_1 \triangleq \Delta_0 S_1 + (1+r)(V_0 - \Delta_0 S_0). \quad (1.10)$$

Although we do not indicate it in the notation, S_1 and therefore X_1 depend on ω_1 , the outcome of the first coin toss. Thus, there are really two equations implicit in (1.10):

$$\begin{aligned} X_1(H) &\triangleq \Delta_0 S_1(H) + (1+r)(V_0 - \Delta_0 S_0), \\ X_1(T) &\triangleq \Delta_0 S_1(T) + (1+r)(V_0 - \Delta_0 S_0). \end{aligned}$$

After the first coin toss, the agent has X_1 dollars and can readjust her hedge. Suppose she decides to now hold Δ_1 shares of stock, where Δ_1 is allowed to depend on ω_1 because the agent knows what value ω_1 has taken. She invests the remainder of her wealth, $X_1 - \Delta_1 S_1$ in the money market. In the next period, her wealth will be given by the right-hand side of the following equation, and she wants it to be V_2 . Therefore, she wants to have

$$V_2 = \Delta_1 S_2 + (1+r)(X_1 - \Delta_1 S_1). \quad (1.11)$$

Although we do not indicate it in the notation, S_2 and V_2 depend on ω_1 and ω_2 , the outcomes of the first two coin tosses. Considering all four possible outcomes, we can write (1.11) as four equations:

$$\begin{aligned} V_2(HH) &= \Delta_1(H) S_2(HH) + (1+r)(X_1(H) - \Delta_1(H) S_1(H)), \\ V_2(HT) &= \Delta_1(H) S_2(HT) + (1+r)(X_1(H) - \Delta_1(H) S_1(H)), \\ V_2(TH) &= \Delta_1(T) S_2(TH) + (1+r)(X_1(T) - \Delta_1(T) S_1(T)), \\ V_2(TT) &= \Delta_1(T) S_2(TT) + (1+r)(X_1(T) - \Delta_1(T) S_1(T)). \end{aligned}$$

We now have six equations, the two represented by (1.10) and the four represented by (1.11), in the six unknowns V_0 , Δ_0 , $\Delta_1(H)$, $\Delta_1(T)$, $X_1(H)$, and $X_1(T)$.

To solve these equations, and thereby determine the arbitrage price V_0 at time zero of the option and the hedging portfolio Δ_0 , $\Delta_1(H)$ and $\Delta_1(T)$, we begin with the last two

$$\begin{aligned} V_2(TH) &= \Delta_1(T) S_2(TH) + (1+r)(X_1(T) - \Delta_1(T) S_1(T)), \\ V_2(TT) &= \Delta_1(T) S_2(TT) + (1+r)(X_1(T) - \Delta_1(T) S_1(T)). \end{aligned}$$

Subtracting one of these from the other and solving for $\Delta_1(T)$, we obtain the “delta-hedging formula”

$$\Delta_1(T) = \frac{V_2(TH) - V_2(TT)}{S_2(TH) - S_2(TT)}, \quad (1.12)$$

and substituting this into either equation, we can solve for

$$X_1(T) = \frac{1}{1+r} [\hat{p} V_2(TH) + \hat{q} V_2(TT)]. \quad (1.13)$$

Equation (1.13), gives the value the hedging portfolio should have at time 1 if the stock goes down between times 0 and 1. We define this quantity to be the *arbitrage value of the option at time 1 if* $\omega_1 = T$, and we denote it by $V_1(T)$. We have just shown that

$$V_1(T) \triangleq \frac{1}{1+r} [\tilde{p}V_2(TH) + \tilde{q}V_2(TT)]. \quad (1.14)$$

The hedger should choose her portfolio so that her wealth $X_1(T)$ if $\omega_1 = T$ agrees with $V_1(T)$ defined by (1.14). This formula is analogous to formula (1.9), but postponed by one step. The first two equations implicit in (1.11) lead in a similar way to the formulas

$$\Delta_1(H) = \frac{V_2(HH) - V_2(HT)}{S_2(HH) - S_2(HT)} \quad (1.15)$$

and $X_1(H) = V_1(H)$, where $V_1(H)$ is the value of the option at time 1 if $\omega_1 = H$, defined by

$$V_1(H) \triangleq \frac{1}{1+r} [\tilde{p}V_2(HH) + \tilde{q}V_2(HT)]. \quad (1.16)$$

This is again analogous to formula (1.9), postponed by one step. Finally, we plug the values $X_1(H) = V_1(H)$ and $X_1(T) = V_1(T)$ into the two equations implicit in (1.10). The solution of these equations for Δ_0 and V_0 is the same as the solution of (1.3) and (1.4), and results again in (1.6) and (1.9).

The pattern emerging here persists, regardless of the number of periods. If V_k denotes the value at time k of a derivative security, and this depends on the first k coin tosses $\omega_1, \dots, \omega_k$, then at time $k-1$, after the first $k-1$ tosses $\omega_1, \dots, \omega_{k-1}$ are known, the portfolio to hedge a short position should hold $\Delta_{k-1}(\omega_1, \dots, \omega_{k-1})$ shares of stock, where

$$\Delta_{k-1}(\omega_1, \dots, \omega_{k-1}) = \frac{V_k(\omega_1, \dots, \omega_{k-1}, H) - V_k(\omega_1, \dots, \omega_{k-1}, T)}{S_k(\omega_1, \dots, \omega_{k-1}, H) - S_k(\omega_1, \dots, \omega_{k-1}, T)}, \quad (1.17)$$

and the value at time $k-1$ of the derivative security, when the first $k-1$ coin tosses result in the outcomes $\omega_1, \dots, \omega_{k-1}$, is given by

$$V_{k-1}(\omega_1, \dots, \omega_{k-1}) = \frac{1}{1+r} [\tilde{p}V_k(\omega_1, \dots, \omega_{k-1}, H) + \tilde{q}V_k(\omega_1, \dots, \omega_{k-1}, T)] \quad (1.18)$$

1.2 Finite Probability Spaces

Let Ω be a set with finitely many elements. An example to keep in mind is

$$\Omega = \{HHH, HHT, HTH, HTT, THH, THT, TTH, TTT\} \quad (2.1)$$

of all possible outcomes of three coin tosses. Let $\mathcal{F}$ be the set of all subsets of Ω . Some sets in $\mathcal{F}$ are $\emptyset$, $\{HHH, HHT, HTH, HTT\}$, $\{TTT\}$, and Ω itself. How many sets are there in $\mathcal{F}$?

Definition 1.1 A probability measure $\mathbb{P}$ is a function mapping $\mathcal{F}$ into $[0, 1]$ with the following properties:

(i) $\mathbb{P}(\Omega) = 1$,

(ii) If $A_1, A_2, \dots$ is a sequence of disjoint sets in $\mathcal{F}$, then

$$\mathbb{P}\left(\bigcup_{k=1}^{\infty} A_k\right) = \sum_{k=1}^{\infty} \mathbb{P}(A_k).$$

Probability measures have the following interpretation. Let A be a subset of $\mathcal{F}$. Imagine that Ω is the set of all possible outcomes of some random experiment. There is a certain probability, between 0 and 1, that when that experiment is performed, the outcome will lie in the set A . We think of $\mathbb{P}(A)$ as this probability.

Example 1.2 Suppose a coin has probability $\frac{1}{3}$ for H and $\frac{2}{3}$ for T . For the individual elements of Ω in (2.1), define

$$\begin{aligned} \mathbb{P}\{HHH\} &= \left(\frac{1}{3}\right)^3, & \mathbb{P}\{HHT\} &= \left(\frac{1}{3}\right)^2 \left(\frac{2}{3}\right), \\ \mathbb{P}\{HTH\} &= \left(\frac{1}{3}\right)^2 \left(\frac{2}{3}\right), & \mathbb{P}\{HTT\} &= \left(\frac{1}{3}\right) \left(\frac{2}{3}\right)^2, \\ \mathbb{P}\{THH\} &= \left(\frac{1}{3}\right)^2 \left(\frac{1}{3}\right), & \mathbb{P}\{THT\} &= \left(\frac{1}{3}\right) \left(\frac{2}{3}\right)^2, \\ \mathbb{P}\{TTH\} &= \left(\frac{1}{3}\right) \left(\frac{2}{3}\right)^2, & \mathbb{P}\{TTT\} &= \left(\frac{2}{3}\right)^3. \end{aligned}$$

For $A \in \mathcal{F}$, we define

$$\mathbb{P}(A) = \sum_{\omega \in A} \mathbb{P}\{\omega\}. \quad (2.2)$$

For example,

$$\mathbb{P}\{HHH, HHT, HTH, HTT\} = \left(\frac{1}{3}\right)^3 + 2 \left(\frac{1}{3}\right)^2 \left(\frac{2}{3}\right) + \left(\frac{1}{3}\right) \left(\frac{2}{3}\right)^2 = \frac{1}{3},$$

which is another way of saying that the probability of H on the first toss is $\frac{1}{3}$.

As in the above example, it is generally the case that we specify a probability measure on only some of the subsets of Ω and then use property (ii) of Definition 1.1 to determine $\mathbb{P}(A)$ for the remaining sets $A \in \mathcal{F}$. In the above example, we specified the probability measure only for the sets containing a single element, and then used Definition 1.1(ii) in the form (2.2) (see Problem 1.4(ii)) to determine $\mathbb{P}$ for all the other sets in $\mathcal{F}$.

Definition 1.2 Let Ω be a nonempty set. A σ -algebra is a collection $\mathcal{G}$ of subsets of Ω with the following three properties:

(i) $\emptyset \in \mathcal{G}$,

(ii) If $A \in \mathcal{G}$, then its complement $A^c \in \mathcal{G}$,

(iii) If $A_1, A_2, A_3, \dots$ is a sequence of sets in $\mathcal{G}$, then $\bigcup_{k=1}^{\infty} A_k$ is also in $\mathcal{G}$.

Here are some important σ -algebras of subsets of the set Ω in Example 1.2:

$$\begin{aligned}\mathcal{F}_0 &= \left\{ \emptyset, \Omega \right\}, \\ \mathcal{F}_1 &= \left\{ \emptyset, \Omega, \{HHH, HHT, HTH, HTT\}, \{THH, THT, TTH, TTT\} \right\}, \\ \mathcal{F}_2 &= \left\{ \emptyset, \Omega, \{HHH, HHT\}, \{HTH, HTT\}, \{THH, THT\}, \{TTH, TTT\}, \right. \\ &\quad \left. \text{and all sets which can be built by taking unions of these} \right\}, \\ \mathcal{F}_3 &= \mathcal{F} = \text{The set of all subsets of } \Omega.\end{aligned}$$

To simplify notation a bit, let us define

$$\begin{aligned}A_H &\triangleq \{HHH, HHT, HTH, HTT\} = \{H \text{ on the first toss}\}, \\ A_T &\triangleq \{THH, THT, TTH, TTT\} = \{T \text{ on the first toss}\},\end{aligned}$$

so that

$$\mathcal{F}_1 = \{\emptyset, \Omega, A_H, A_T\},$$

and let us define

$$\begin{aligned}A_{HH} &\triangleq \{HHH, HHT\} = \{HH \text{ on the first two tosses}\}, \\ A_{HT} &\triangleq \{HTH, HTT\} = \{HT \text{ on the first two tosses}\}, \\ A_{TH} &\triangleq \{THH, THT\} = \{TH \text{ on the first two tosses}\}, \\ A_{TT} &\triangleq \{TTH, TTT\} = \{TT \text{ on the first two tosses}\},\end{aligned}$$

so that

$$\begin{aligned}\mathcal{F}_2 &= \{\emptyset, \Omega, A_{HH}, A_{HT}, A_{TH}, A_{TT}, \\ &\quad A_H, A_T, A_{HH} \cup A_{TH}, A_{HH} \cup A_{TT}, A_{HT} \cup A_{TH}, A_{HT} \cup A_{TT}, \\ &\quad A_{HH}^c, A_{HT}^c, A_{TH}^c, A_{TT}^c\}.\end{aligned}$$

We interpret σ -algebras as a record of information. Suppose the coin is tossed three times, and you are not told the outcome, but you are told, for every set in $\mathcal{F}_1$ whether or not the outcome is in that set. For example, you would be told that the outcome is not in $\emptyset$ and is in Ω . Moreover, you might be told that the outcome is not in A_H but is in A_T . In effect, you have been told that the first toss was a T , and nothing more. The σ -algebra $\mathcal{F}_1$ is said to contain the “information of the first toss”, which is usually called the “information up to time 1”. Similarly, $\mathcal{F}_2$ contains the “information of